



News release

CA 2042
TR
N26

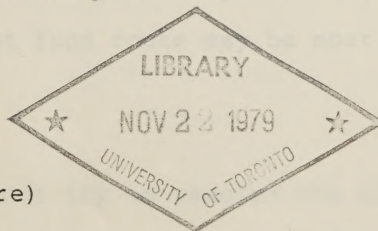
October 18, 1979

TORONTO -- How to pay the future pension benefits of Canada's growing elderly population, is the subject of a staff study released today by the Ministry of Treasury and Economics.

"The economics and financing of pension plans in Canada is a current issue of major importance in public finance. In potential magnitude and impact, it rivals the national tax reform of the early Seventies," says the preface to the paper.

The main focus of the study is the Canada Pension Plan which is administered by the federal government on behalf of all provinces, except Quebec. But the analysis also applies to pension schemes in general.

(more)





It is generally agreed that Canadians are going to have to pay more in future to finance pension benefits because the number of elderly people is growing faster than the total population. The Treasury document examines two methods of paying for these benefits: pay-as-you-go financing and investment fund financing. In reviewing the economic and financial arguments for both it shows how under the pay-as-you-go method, wage and salary earners will make low pension contributions during the next decade, but that at some point after that their contribution would be markedly increased. With investment fund financing, people would contribute more of their earnings in the near term, but the contribution rate would remain stable.

To the question, which is cheapest and best in the long run, the paper says a strict financial, or cash-in-cash-out kind of accounting suggests that the pay-as-you-go method is best. On the other hand, taking into account the overall impact of pension plan investments on the economy, the investment fund route may be most beneficial.

The document does not try to resolve the dilemma because broad social considerations must be taken into account as well as financial and economic criteria.

It is generally agreed that Canada has the right
to have its pay rate in line with its domestic business
conditions. The matter of a higher pay rate is a matter
of domestic legislation. The Treasury Department estimates
the benefit of paying for these benefits pay-as-you-
go financing and investment fund financing. In 1965
the economic and financial arguments for both it show
that the pay-as-you-go method, while not entirely
will make the pension contributions during the next decade,
and that at some point when the contribution would
be seriously increased. With investment fund financing,
people would contribute more of their savings in the
near term, but the contribution rate would remain steady.

In the question, which is whether and how
to the long term the government pays a higher rate, the
cash-in-hand-kind of contribution would be the
pay-as-you-go method is best. On the other hand, taking
into account the overall impact of the plan on the
the economy, the investment fund type may be more
beneficial.

The document does not try to resolve the dilemma
between social and financial considerations. It is
noted as well as financial and economic aspects.

The Ontario Treasury paper will contribute to the discussions that will follow the release of the report of the Royal Commission on the Status of Pensions in Ontario. Also, during the next two years the provinces and the federal government will be deciding on the future financing of the Canada Pension Plan.

The paper is number 16 in a series of Ontario Treasury Staff Studies.

Ref: Dave Stouffer
Taxation and Fiscal Policy Branch

(416) 965-6869

N.B. A summary is attached

Digitized by the Internet Archive
in 2022 with funding from
University of Toronto

ISSUES IN PENSION POLICY

A summary of three studies

1. Demographic and Economic Implications of Canada's Ageing Population

This first study looks at the economic implications of moving to a population with a higher proportion of elderly people and a lower share of young people.

The paper's demographic projections show that by the year 2025 Canada's elderly will make up between 12 and 18 per cent of the population. This is compared with 8.5 per cent today.

It is noted that population forecasting is an uncertain science because future fertility rates and immigration rates cannot be known with certainty.

Economic Implications

The concept of dependency refers to the number of younger and older people who must be supported by the working-age population.

The projections indicate that while the number of elderly people will increase the proportion of young dependents will decline. Overall, dependency will be below historical levels for the next 50 years.

However, the cost of supporting elderly people is higher. One estimate says that on average it is 2 1/2 times as expensive to support an aged dependent as a young dependent. Under this assumption, effective total dependency will exceed the 1976 level by 1991 and by 2031 will be 43 per cent above the current level.

The study also looks at the implications of ageing for personal saving in the Canadian economy. It is expected that movement of the "baby boom" generation into its prime saving years will continue to have a positive influence on saving until 1985. Subsequently, this effect will be outweighed by the increasing number of elderly and the saving rate will decline.

It is noted that the transition to an aged population will take 40 years which is a lengthy period for adjustment. Real per capita income can be expected to increase during this period by more than enough to pay for the higher cost of dependency.

2. The Economics of Financing National Pension Plans

The second study looks at some economic issues involved in the long-run financing of national pension schemes, such as the Canada Pension Plan. It examines two basic alternatives; pay-as-you-go financing and investment fund financing.

The method of financing a national pension plan will affect the country's saving rate. An increase in the saving rate will generate additional capital investment which will increase the economic well-being of future generations, but the current generation will pay through reduced consumption.

Investment fund financing would increase the saving rate. Pay-as-you-go financing would not increase the saving rate, but it is not clear whether it would reduce it.

Investment fund financing involves higher initial contribution rates. However, the fund can act as an economic buffer against the swing to a more elderly population. Under a pay-as-you-go system contribution rates can be lower at the start but would have to be increased in the future when the ratio of pensioners to contributors increases.

In future, a national pension plan can be financed by one of these two methods. The choice will involve an important trade-off between present and future consumption. The paper does not present a favoured option since this question must be answered on social as well as economic grounds.

3. The Financing of Public and Private Pension Plans: An analysis from Two Perspectives

The final study evaluates the cost of financing public and private pension plans from two perspectives: financial and economic. Each perspective leads to a different conclusion.

The first section explains the relationship between pay-as-you-go and investment fund financing. The cost of investment funded pensions is mainly related to the rate of return received by the fund. The cost of pay-as-you-go plans is primarily related to the growth rate in the earnings of contributors -- the higher the growth rate the lower the cost.

The study shows that the cost of providing pensions by investment fund financing is less than pay-as-you-go only when the return earned by the fund is greater than the growth rate in contributor earnings.

The study then evaluates pension costs under financial and economic criteria.

The Financial Perspective

During the 25-year period 1952-76, the average annual growth rate of earnings available to national government pension plans was 9.75 per cent. This was greater than the financial returns to bonds, mortgages and equities which ranged from 5.73 to 8.12 per cent. This indicates that pay-as-you-go financing is

preferred for national pension plans. However, during the same period the earnings growth rate available to individual employer-sponsored pension plans was only 6.37 per cent. This lower figure results from labour-force growth assumptions which must be made in private plans. Since the return to financial assets other than Government of Canada bonds exceeded 6.37 per cent, the investment fund route was preferable for employer-sponsored plans.

The Economic Perspective

This section of the paper uses the measure of total return to capital investment. Economists use this measure to determine the total return to society from investment. It is higher than the financial rate of return because it includes taxes paid to governments in addition to interest and dividend yields.

During the period 1965-74 the total real economic return to capital investment in Canada has been estimated at 10.78 per cent. The comparable real growth rate in earnings was 7.10 per cent.

Using this economic criteria, the effective cost of both national and employer-sponsored pension benefits would be less under investment fund than pay-as-you-go financing.

The results of this analysis should provide a useful contribution to future discussions concerning national pension plan financing in Canada.



3 1761 11546476 0